Long-Term Policy Options

for the Palestinian Economy

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Acronyms and Abbreviations

AVE	Ad Valorem Equivalent
CACM	Central American Common Market
CPI	Consumer Price Index
CU	Customs Union
DW	Durbin Watson
EFTA	European Free Trade Area
EU	European Union
FIAS	Foreign Investment Advisory Service
FTA	Free Trade Area
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNI	Gross National Income
GPA	Government Procurement Agreement
GS	Gaza Strip
IBRD	International Bank for Reconstruction and Development
ICBS	Israeli Central Bureau of Statistics
IFC	International Finance Corporation
IMF	International Monetary Fund
ITA	Information Technology Agreement
MENA	Middle East and North Africa
MFN	Most Favored Nation
NAFTA	North America Free Trade Agreement
NDTP	Non-Discriminatory Trade Policy
NIS	New Israeli Shekel
NTM	Non-Tariff Measure
OECD	Organization for Economic Cooperation and Development
PA	Palestinian Authority
PCBS	Palestinian Central Bureau of Statistics
PLC	Palestinian Legislative Council
PLO	Palestine Liberation Organization
PM	Prime Minister
PP	Paris Protocol
PSI	Palestinian Standards Institute
ROO	Rules of Origin
ROW	Rest of the World
SACU	Southern African Customs Union
TFP	Total Factor Productivity
TRIPS	Intellectual Property Rights
UNCTAD	United Nations Conference on Trade and Development

UNRWA	United Nations Relief & Works Agency
US	United States
US$	United States Dollar
USAID	United States Agency for International Development
VA	Value Added
VAT	Value-Add Tax
WB	West Bank
WBES	World Business Environment Survey
WBG	West Bank and Gaza
WBI	World Bank Institute
WTO	World Trade Organization

Executive Summary

Introduction

The Palestinian economy has been closely integrated with its larger and richer neighbor Israel since the 1967 Israeli occupation of the Palestinian Territories. Trade between the Palestinian Territories and Israel effectively became internal, reflecting a customs union trade regime, and a large share of the Palestinian labor force was employed by Israeli firms. The result today is a high degree of Palestinian dependence on the Israeli economy: trade volumes with Israel are very large – 96 percent of Palestinian exports are destined for Israel – and labor flows into the Israeli labor market account for nearly a quarter of total Palestinian employment. The main activities of the Palestinian economy are shaped by the nature of economic relations with Israel. Palestinian production is largely oriented toward providing inexpensive, low value-added products for Israeli consumption or re-export, and specialization in low-productivity construction and agriculture sector jobs.

The advent of the peace process in the early 1990s and the 1994 signing of the Paris Protocol formalized the Palestinian-Israeli economic relationship between two administratively and physically distinct entities, although considerable overlap remained. The Paris Protocol gave the Palestinians administrative autonomy over the Palestinian Territories in terms of public service delivery, and formalized policies of economic cooperation and integration with Israel relating to the exchange of goods, fiscal policy, currency arrangements, and labor services.

Economic outcomes post-Oslo. Despite high expectations for economic normalization and growth following the peace accord and Paris Protocol, economic performance was modest at best, and suffered periods of sharp decline. The deep recession of 1995-1996 was the result of Israeli security measures under which the West Bank and Gaza Strip were effectively cut off from Israel and from each other. The prospect and unpredictability of closures created an environment of uncertainty and risk. This in turn was compounded by extraordinarily high transactions costs and restrictions on access to alternative markets for import or export under the agreed trade regime. Domestic output and exports declined, private sector investment dried up, and labor flows to Israel were sharply curtailed, all of which contributed to joblessness and rising poverty.

When security measures eased, particularly in 1998, 1999 and the first part of 2000, the economy returned to its historical growth trend of 5 percent annual GDP growth. But the anticipated income convergence with Israel did not materialize for a variety of reasons. Although it provided preferential Palestinian access to Israeli markets, the customs union trade policy effectively limited Palestinian imports to relatively expensive Israeli goods. The net effect restricted domestic Palestinian productivity growth and hindered expansion of export products and markets beyond Israel. Palestinian and Israeli labor market integration produced mixed effects: whereas access to high-paying Israeli jobs increased Palestinian employment and household incomes, it also raised domestic Palestinian wages, dampening labor demand and diminishing Palestinian competitiveness on export markets. The uncertain business environment – exacerbated by closure policy and a weak institutional framework for promoting investment – discouraged investors due to the perceived risks. Together, these policies resulted in a development path of Palestinian economic dependence on Israel.

Although the Paris Protocol and the broader economic model of integration with Israel had many shortcomings, important progress was achieved during the Interim Period, generating optimism that a final status agreement based on the peaceful coexistence of two neighboring sovereign entities was attainable. But serious challenges emerged in 1999 and 2000 with the start of final status negotiations over the contentious issues of borders, Jerusalem, access to water resources, and the right of return of Palestinian refugees.

Negotiations broke down as tensions erupted into civil conflict in September 2000, plunging the Palestinians into political uncertainty and severe economic crisis that is ongoing today. Closures and confrontation resulted in a sharp drop in trade, employment, and investment, and a doubling of already high transport costs. Real GDP fell 6 percent for the year 2000 (despite robust growth during the first three quarters), and by an additional 12 percent in 2001, with critical implications for welfare: per capita income plummeted by 10 percent in 2000 and another 19 percent in 2001.

In light of deteriorating economic relations between Israel and the West Bank and Gaza, and suspended peace negotiations, it is timely at this juncture between the lapsed Interim Period and a final status agreement to examine past experience with a view to assessing the policy choices facing Palestinian policymakers in the future. The post-Oslo experience points to failed economic normalization and income convergence with Israel. Several reasons for these failures have been advanced, including poor implementation of the Paris Protocol, as well as fundamental flaws inherent to the protocol itself. For instance, loopholes in the trade rules for customs crossing procedures and inadequate dispute settlement mechanisms enabled Israel's politically-motivated closure policy to circumvent the agreed economic objectives of cooperation and Palestinian development. Arguments that the protocol was destined to fail are based on continued Palestinian dependency and vulnerability doomed to generate poor growth outcomes due to low value-added activities and a lack of technology transfer, or simply the fact that the Paris Protocol represented a temporary agreement falling mid-way between sovereignty and full partnership, but with no Palestinian recourse to address shortcomings. In this sense, the protocol was an unenforceable and incomplete contract that worked to Israel's advantage.

Overlap of politics and economics. The experience under the Paris Protocol illustrates the degree to which political and economic factors are intertwined; both types of factors need to be addressed in a comprehensive framework. The fact that political pressures from Israeli security concerns introduced severe economic hardship on the Palestinians and threatened newly-gained Palestinian autonomy contributed to the unraveling of the interim agreement. The economic environment of uncertainty, risk, costly transactions, and inadequate legal, regulatory and financial institutions hampered private sector development and especially Palestinian–Israeli partnerships and business networks at the firm level, effectively weakening an important tie that holds civil society together. These factors further undermined Palestinian economic growth, laying the foundation for political crisis and civil conflict.

Study objectives. Given the problems associated with the existing policy framework, this analysis examines alternative policy options that will face Palestinian policymakers in the event of a peace agreement with Israel. These future policy choices relate to trade, labor mobility to Israel, and the business environment and associated public-private interactions. In a first stage, each policy area is analyzed separately, that is, in a partial equilibrium context independent of the others without accounting for broader intersectoral relationships.

In a second stage, the analysis brings together these separate areas into an integrated framework. A range of assumptions vis-à-vis the nature of borders between West Bank and Gaza and Israel is delineated, tying together the trade, labor and private sector development considerations to measure their combined impact on growth prospects. The analysis develops scenarios to reflect different combinations of future policy options linked to the nature of borders with Israel. This simulation exercise illustrates the relative merits of each scenario, the associated trade-offs, and the prospects for economic growth in the event of a peace agreement and a completion of final status negotiations. Welfare implications and the capacity of the social safety net to address present and future Palestinian needs are critically important, and will be addressed in a companion World Bank study under preparation.

Existing Trade Distortions and Future Policy Options

Pros and cons of the existing customs union. Israel is by far the West Bank and Gaza's most important trade partner, dominating both imports and exports (see Figures 1 and 2 below). The modified customs union currently in place is one-sided, favoring Israel in several ways. The external tariff on third-party countries is set by Israel without regard to Palestinian comparative advantage. Although Israeli tariffs plus purchase tax average 11 percent, the effective rate is a much higher 16.6 percent on Palestinian imports due to the different types of goods imported by West Bank and Gaza (WBG). Furthermore, the Paris Protocol allows only limited Palestinian access to Egyptian and Jordanian markets. Because Israel controls all borders in the Palestinian Territories, Palestinian trade must be conducted through Israel rather than directly with third-party countries.

Figure 1: WBG Imports by Origin

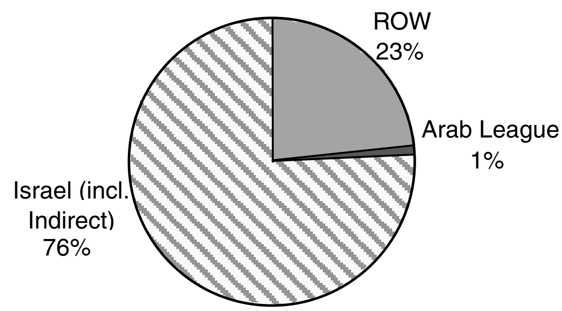
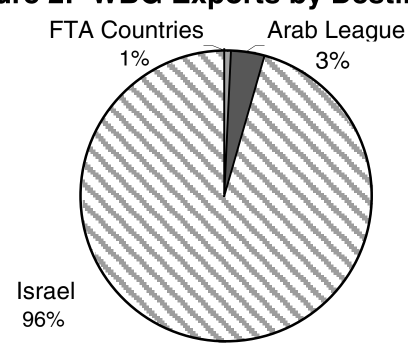


Figure 2: WBG Exports by Destination



Requiring all goods to pass through Israel or Israeli-controlled borders creates at least two problems:

(i) Palestinian traders incur higher transport costs than if trading directly; and

(ii) the Palestinian Authority (PA) loses out on trade tax and VAT revenue from goods nominally imported into Israel but subsequently re-exported to the West Bank and Gaza without being properly accounted for – and taxed – as a trade transaction.

This lost revenue associated with indirect imports amounts to an estimated US$174 million per year (see Table 1). Additional losses are incurred by WBG in welfare terms, because the US$900 million trade deficit with Israel constitutes a negative net transfer equivalent to US$99-140 million (compared to a non-discriminatory trade policy). This means that Israel gains more than WBG from preferential access to Palestinian markets under the customs union.

On the other hand, WBG gains certain advantages from being in a customs union with Israel, such as preferential access to the large Israeli market, albeit still one-sided during closures. In addition, Israel's recent trade liberalization has allowed liberalization for Palestinian imports as well. And finally, the Israeli tax authority collects taxes on behalf of the PA and remits the proceeds to the PA (although currently suspended under the intifada), greatly simplifying the PA's role and reducing its administrative costs by an estimated US$48 million annually.

Comparing a CU, FTA and NDTP. In Table 1, the costs and benefits of a customs union (CU) are compared to alternative trade regimes possible under a final status agreement, namely a non-discriminatory trade policy (NDTP) and a free trade area (FTA). By making concrete estimates of the pros and cons of the customs union compared to an NDTP, the losses incurred by the Palestinian economy under the existing customs union are estimated at US$225-266 million annually (depending on the degree of smuggling).

Table 1: Net Gain of CU, FTA Compared to NDTP (US$ mn per year)

	No Smuggling	Smuggling
CU:		
Indirect imports (taxes)	-174	-174
Trade deficit (welfare)	-140	-99
Border cost savings	48	48
Net Gain of CU	**-266**	**-225**
FTA:		
Trade deficit (welfare)	-140	-99
Rules of Origin	-85	-85
Net Gain of FTA	**-225**	**-184**

An NDTP is also superior to an FTA, based on a tax revenue/welfare calculation (see Table 1). Under an FTA, trade between WBG and Israel is still free, implying the same welfare loss from the trade deficit as under a CU (ranging from US$99-140 million). But there are additional costs for complying with rules of origin necessary to avoid trade deflection under an FTA. These costs are borne by the PA in terms of border administration, as well as by exporters and consumers through higher import prices. Moreover, there are no border savings to offset these losses, such that in net terms, an FTA would cost at least US$184-225 million annually (depending on the degree of smuggling). The costs of an FTA are even higher in light of the following related issues: potential trade diversion, welfare losses due to WBG's higher propensity to import, and enforcement complications resulting from multiple and overlapping FTAs.

When the customs union is weighed against an FTA, however, the CU is superior from the perspective of tax revenues and administrative costs. An FTA would require setting up and administering customs border stations, but this added cost would not be accompanied by the added benefit of tax revenues on Israeli imports, which would continue to be free. Moreover, the introduction of rules of origin would reduce Palestinian access to Israeli markets. And finally, efficiency and welfare losses would arise under an FTA from trade diversion under which Palestinian producers use more expensive Israeli imports rather than less costly alternatives from third-party sources in order to meet rules of origin criteria for exporting final goods to Israel duty-free.

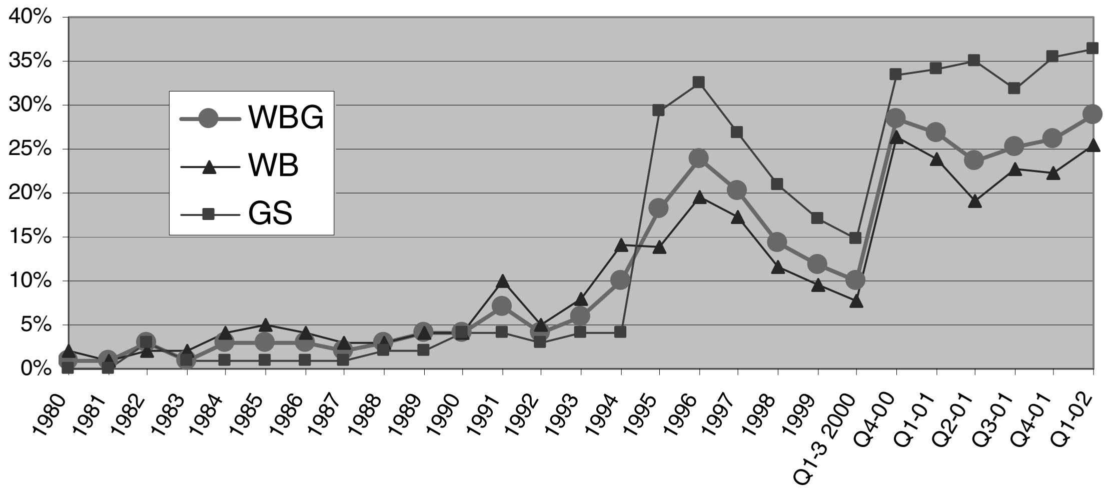
Analyzing trade policy choices in a partial equilibrium framework – that is, from a tax revenue and welfare perspective independent of other sectors of the economy – an NDTP is superior to both an FTA and the existing customs union, assuming open and transparent trade policy enforced by credible lock-in mechanisms. It is important to note, however, that the costs to a CU are offset to a large degree by Palestinian access to the Israeli labor market (addressed below). Furthermore, if for political reasons the customs union remains in effect under final status, several improvements could be made to counter Palestinian losses, for example by adopting a macro-based revenue sharing formula, and/or direct Israeli compensation of WBG for the losses it incurs under a CU.

Labor Market Outcomes

<u>Historical trends</u>. The costs borne by WBG through its membership in a customs union with Israel are partly offset by Palestinian access to the Israeli job market, which increases aggregate employment and raises incomes. On the other hand, this access distorts wages within the Palestinian economy, hurting competitiveness. In the past, rapid population growth strained the capacity of the Palestinian economy, leading to excess labor supply despite low participation rates – particularly among women. As a result, many workers sought employment elsewhere, primarily in Israel. Prior to the ongoing crisis, nearly a quarter of Palestinian employment was in Israeli jobs, where wages are significantly higher than in WBG. Israel began to restrict Palestinian labor inflows in the early 1990s by introducing work permit requirements. But the Oslo accords marked a fundamental shift in Israeli labor policy, as mobility restrictions were enforced, including periodic border closures and at times extreme restrictions (i.e., internal closures) during which Palestinians could not leave their villages. During closures, very few workers from Gaza could reach their jobs in Israel or the settlements, but West Bankers had slightly more flexibility, due to the porous border with Israel.

Closures were particularly severe in 1995 and 1996, leading to a drop in labor flows to Israel and high Palestinian unemployment, which spiked to 25 percent in 1996, up from modest levels in the early 1990s (see Figure 3). This is a dramatic change from the 1980s when unemployment was negligible and movement restrictions did not exist. The PA responded to skyrocketing unemployment by creating jobs in the civil service. Although this strategy coincided with the PA's expanded responsibilities post-Oslo and the need to set up the main institutions of governance and public service delivery, public employment grew faster than necessary, engendering an unsustainably large wage bill.

Figure 3: Unemployment

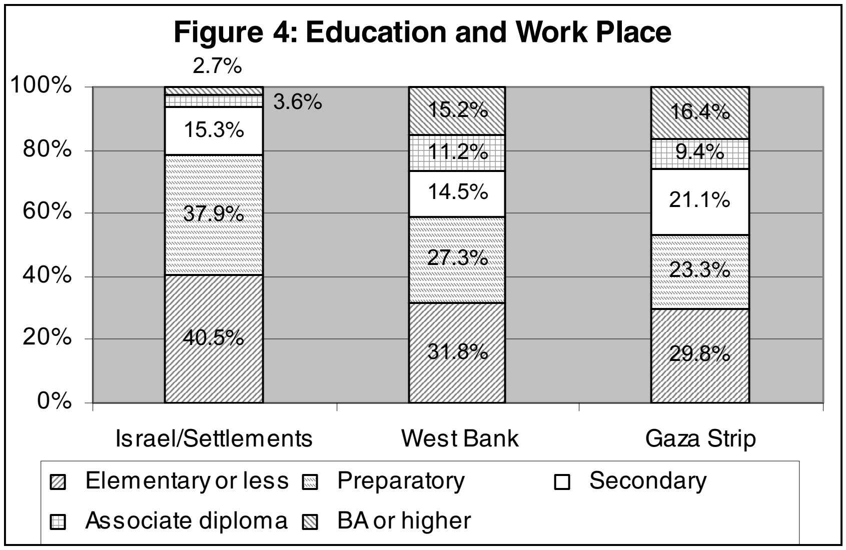


As the security climate improved, labor flows to Israel regained much of their earlier importance in providing Palestinian jobs, and unemployment declined in 1998 and 1999, falling below 10 percent in mid-2000. The September 2000 outbreak of the intifada led to sharply higher unemployment as closures precluded workers from reaching their jobs and prolonged civil strife disrupted domestic economic activity.

Profiles of the employed and unemployed. Labor force survey data from the Palestinian Central Bureau of Statistics provides information on the characteristics of the employed and unemployed. For example, the average age of employed workers (33 years for men and 35 years for women) is higher than the average for the unemployed (29 years for men and women), implying that the young are more affected by unemployment. Unemployed men have lower educational attainment than women; in fact, three-fourths of unemployed women have a post-secondary degree, compared to 13 percent of unemployed men. Educational profiles also vary by place of work. Figure 4 shows that almost 80 percent of Palestinians working in Israel have a preparatory education or less, reflecting a lower education level than among those employed domestically. Workers in Gaza have a slightly higher educational profile than those working in the West Bank.

The data also indicate that government employees are more educated than those in the private sector, with 52 percent holding a post-secondary degree or higher, compared to only 14 percent among non-PA workers. Similarly, government employment accounts for a majority of skilled occupations, suggesting little private sector demand for high skills.

Looking at the sectoral composition of employment, 59 percent of Palestinians employed in Israel work in construction and another 10 percent work in agriculture – both low productivity sectors. Israeli policy to limit Palestinian labor inflows effectively increases the wage gap between domestic and Israeli jobs, making jobs in Israel particularly attractive to less educated Palestinians in low-skill occupations.



<u>Palestinian wages in WBG and Israel</u>. Mincer-type wage regressions indicate that the returns to working in Israel are extremely high: 85 percent for a worker from Gaza, and 61 percent for a West Banker, controlling for individual characteristics. In this environment, the domestic economy struggles to create adequate jobs for the fast-growing but fairly well-educated labor force, putting pressure on the PA to step in by creating more civil service jobs.

Although the returns to education are positive and increasing, these are fully offset by the returns to working in Israel. Moreover, the higher Israeli wage actually draws up domestic wages in WBG, making them less competitive and dampening domestic labor demand. This very real distortion from limited access to Israeli jobs hurts Palestinian economic development by underutilizing available human capital resources and creating a labor market that specializes in low value-added activities. This in turn does not facilitate skills acquisition through knowledge-sharing or learning-by-doing – the expected gains from labor migration. In addition, the relatively high wage does not attract investors or technology to increase productivity in export sectors. During the Interim Period, Palestinian growth and economic development was not export-led but rather was driven by consumption through higher incomes from workers' remittances from Israeli jobs. The positive consequences of this growth model include higher household incomes and lower poverty when labor can move relatively freely. But the downside – especially during periods of closure – involves uncertainty, income volatility, high unemployment and poverty, uncompetitive domestic wages, and substantial vulnerability to external shocks.

Modeling the labor market. To assess the demand and supply pressures at work in the Palestinian and Israeli labor markets, this analysis develops a partial equilibrium model reflecting labor market segmentation, distorted wages, and structural unemployment in the Palestinian economy. Labor market equilibrium is characterized by wage gaps among domestic wages in the West Bank and Gaza Strip, and wages in Israel, which are the result of limited Palestinian labor supply to Israel, high unemployment, job search and transport costs for those commuting to Israel, and a risk premium incurred by Israeli employers due to absenteeism during closures. If the number of Palestinians allowed into Israel rises – treated as an exogenous shock – both unemployed and domestically employed Palestinians are drawn to the higher Israeli wage. Although unemployment falls, it falls by less than total new labor flows to Israel, pulling up domestic wages due to the decline in domestic labor supply.

At the same time, a more flexible border policy associated with higher labor flows reduces both Palestinian commuting costs and the unit labor cost to Israeli employers, leading to a narrowing of the wage gap between WBG and Israel. Because foreign workers in Israel are close technical substitutes for Palestinian labor, the inflow of Palestinians displaces a certain number of foreign workers, but less than one-for-one, given that foreign workers earn less on average than Palestinians. As reported in Table 2, simulations of the labor model indicate that an increase in labor flows to Israel by 10,000 workers (8,000 from the West Bank and 2,000 from the Gaza Strip) would reduce Palestinian unemployment by only 4,500 in total (3,300 in the West Bank and 1,200 in Gaza Strip). This would drive down the unemployment rate from 11.8 to 11.2 percent, and concurrently reduce employment within WBG by 5,500. Wages in both the West Bank and Gaza Strip would actually rise, slightly reducing the gap with wages in Israel.

Table 2: Predicted Results of Increased Labor Flows to Israel

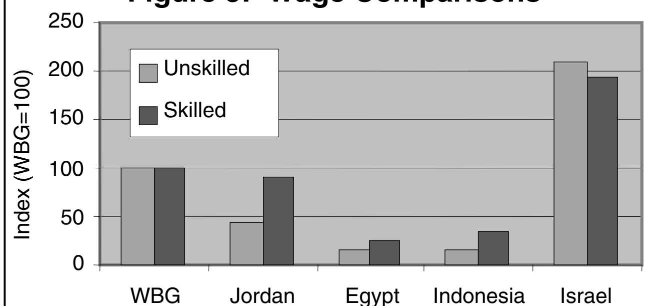
Variable	Initial Value (1999)	Change	New Value
Workers from West Bank:			
Employed in Israel	107,178	8,000	115,178
Employed in West Bank	314,465	-4,719	309,746
Unemployment rate	9.6%	-3,281	8.9%
Competing foreign employment in Israel	200,000	-4,290	195,710
Wage in Israel	104.4	1.5%	105.9
Wage in West Bank	67.5	3.8%	70.1
Workers from Gaza Strip:			
Employed in Israel	27,368	2,000	29,368
Employed in Gaza Strip	143,091	-779	142,312
Unemployment rate	17.0%	-1,221	16.4%
Competing foreign employment in Israel	50,000	-1,095	48,905
Wage in Israel	93.4	1.4%	94.7
Wage in Gaza Strip	53.4	3.6%	55.3

This estimation exercise demonstrates how increasing access to Israeli jobs produces both winners and losers. Clearly the Palestinians who find a new job in

Israel are better off, but so are those already employed in Israel, due to the marginal decline in commuting costs and the higher Israeli wage. Employers in Israel are winners as well, since the wage increase is offset by the decline in the risk premium, such that their net unit labor cost declines. Employers in WBG, however, bear the cost of increased labor flows to Israel through higher wages, making them less competitive. And finally, foreign workers who are displaced by incoming Palestinians also lose.

Even in the framework of this partial equilibrium labor analysis, the above quantitative estimates illustrate the trade-offs associated with Palestinian reliance on Israeli labor demand. On the one hand, labor market integration raises employment levels and incomes, with positive feedback effects on domestically produced goods and services. In the past, these domestic demand effects were inadequate to sustain robust private sector growth, however. The downside to Palestinian dependence on jobs in Israel includes vulnerability to border closures and – more importantly – distorted wages that inhibit the domestic labor market and private sector development through weak competitiveness and specialization in low-productivity occupations. Figure 5 shows how Palestinian wages compare unfavorably to competitor countries (other than Israel). Although not captured in the partial equilibrium labor market model presented in this analysis, noncompetitive wages hurt domestic output and productivity growth by dissuading investment due to the high cost of doing business.

Figure 5: Wage Comparisons



Source: World Bank and USAID (1996)

<u>Future labor policy</u>. The labor model's estimates shed light on the impact of future policy changes vis-à-vis labor flows between the Palestinian and Israeli economies. Against this background, the analysis considers potential labor policy changes in the event of a peace accord with Israel. The options depend on the nature of borders and the types of labor controls imposed by Israel, which are likely to differ from current arrangements. A certain degree of integration with the Israeli labor market will persist, however.

Under a continuation of relatively open borders between the West Bank and Israel, Palestinians would continue to commute to Israeli jobs at least at the current crisis level of 50-70,000 workers, even if Israel adopts a very restrictive policy toward Palestinian labor. However, it is more likely that a peace agreement will be accompanied by normalization of cross-border economic relations and a restoration of trust on the ground, thereby increasing labor mobility and reducing transactions costs. This suggests two possible scenarios:

i. Palestinian labor supply to Israeli jobs keeps pace with labor force growth in WBG; or

ii. Palestinians obtain increased access to Israeli jobs, but face higher transportation and search costs due to tighter border crossing procedures, resulting in slower growth of Palestinian employment in Israel.

The first scenario is consistent with a continuation of the customs union and free movement of goods between WBG and Israel. The second scenario could arise in the context of a change in trade regime to an FTA.

Under a third possible solution – less cooperative than the other two – economic separation under final status could involve physical borders across which the movement of all goods and factor services is tightly controlled. This scenario, consistent with an NDTP, would discourage Palestinian employment in Israel, keeping mostly informal Palestinian worker flows at low levels.

The above-described range of labor policy options under a final status agreement suggests that the potential magnitude of labor flows in the long run – say, in 2010 – is likely to fall between 70,000 and 165,000, compared to 128,000 in 1999 (excluding East Jerusalem). For any projection in this range, the distorting effects of a high Israeli wage will continue to pull domestic Palestinian wages above their market-clearing level and depress domestic labor demand. Likewise, the attendant underutilization of human capital will have important negative dynamic implications, namely continued depreciation of existing skills and low incentive for skills acquisition, both of which discourage human capital accumulation which is crucial to raising productivity in the long run.

The Business Environment and Private Sector Growth

Policy instability and uncertainty. The existing trade and labor distortions described above both lead to low-productivity, low-growth outcomes through export and labor specialization in low value-added activities. This distorted incentive framework is exacerbated by high risk and uncertainty linked to the interim political accord, unclear prospects for future economic and political arrangements, and a lack of reliable property rights in this context. Almost 80 percent of Palestinian private firms responding to a survey on the business environment in WBG prior to the intifada reported policy instability and uncertainty as the greatest impediment to operations. Another major source of difficulty for private agents are Israeli security measures that result in crippling transactions costs.

Taken together, these features do not create an environment conducive to private investment in start-ups or expansion of existing businesses. Although the

Paris Protocol attempted to address some of these constraints – through modifying the customs union to allow limited Palestinian trade with its Arab neighbors, creating the Palestine Monetary Authority which allowed the entrance of domestic and foreign banks, establishing legal institutions, and developing a regulatory framework – the resulting progress and improvements were severely challenged by the uncertainty, mobility restrictions, and high transactions costs attendant to security measures.

The economy's growth prospects (discussed below) are brighter under scenarios of normalization with Israel, assuming a resolution of the ongoing conflict. But addressing trade and labor policies alone will not automatically trigger a large private sector response, even though a negotiated settlement would greatly improve the business environment by reducing the risk associated with political and ultimately economic uncertainty. The current prospects for extensive job creation in the constrained Palestinian business environment are dim, especially in view of rapid labor force growth. The PA lacks the resources and capacity to continue absorbing job seekers, implying that the private sector will need to pick up the slack in order to support improved Palestinian economic performance.

<u>High production costs</u>. In addition to the high cost of Israeli security procedures, other distortions raise production costs, diminishing Palestinian competitiveness. High transportation costs for the effectively land-locked WBG raise the final price of exports as well as the cost of imported inputs. The relatively high market wage renders Palestinian labor-intensive products more expensive. Palestinian producers also face relatively high prices for production facilities such as land, electricity, and water. The expensive cost structure faced by manufacturers in WBG presents severe challenges for Palestinian competitiveness, many of which are by-products of the interim economic arrangements over which the PA has limited recourse in the present environment.

<u>Corrective policies</u>. The PA nevertheless has some tools at its disposal today to ease constraints facing private agents, improve the institutional framework for investment, and enhance public-private interactions. These include policy measures to address areas currently within Palestinian control – namely, strengthening the Rule of Law, promoting a strong financial system, reducing anticompetitive practices, increasing accountability of the public sector, improving revenue administration, and raising the efficiency of the public sector by allowing the private sector to compete in service delivery.

The existing institutional framework vis-à-vis legal and regulatory systems and property rights does not inspire confidence, dissuading potential investors due to the implied risks. Specifically, investors need assurances that commercial disputes can be resolved fairly and in a timely fashion through the court system. The Palestinian courts and judiciary are ranked lowest among PA services. Security and military courts have weakened the independence and effectiveness of the judiciary, and Palestinians have resolved disputes through appeals to security personnel rather than in civil courts. The executive and judicial powers of government need to be separated – as laid out in the recently ratified *Basic Law* and *Independence of the Judiciary Law* – and a backlog of commercial legislation needs passing and implementation, in order to support the transactions of a market economy.

The PA also falls short in its regulatory functions. An efficient private sector in WBG requires regulatory institutions that are separate from both the policy-making functions of PA ministries and the investment activities of the government. This includes independent regulation of utilities and financial intermediaries, for example.

Although the banking sector has grown significantly post-Oslo, reflected by very large deposits, credit availability remains inadequate, with lending dependent on traditional collateral requirements that are particularly restrictive in the Palestinian environment of few land titles. This especially hurts small-scale entrepreneurs, who are forced to rely on self-financing rather than borrowing at high interest rates. Allowing a wider range of assets to be used as collateral, improving auditing and accounting standards, and adopting more flexible methods to assess credit risk are all measures that could promote investment by easing access to formal credit markets.

The investment climate in WBG is further marred by perceived anticompetitive practices by the PA – either through its direct involvement in productive activities such as import monopolies for gas and cement (imposed under the Paris Protocol to protect Israeli monopolies), or indirectly through PA equity participation in private firms. This lack of transparency, quite distinct from explicit forms of corruption, discourages investors for fear of unfair competition.

Related to transparency, PA consultation with the private sector has been weak in the past, according to firms surveyed in May 2000. International experience shows important benefits from business-government consultation, including:

- better information for public decisions;
- broader ownership of reforms and enhanced credibility of public sector decisions;
- improved accountability and transparency of decisions;
- increased resources to implement agreed policy by mobilizing financial support from the business community; and
- lower costs of business-government transactions through increased trust.

Recent PA efforts such as the National Trade Dialogue Conference suggest a shift in the PA's approach to setting policy, namely by taking on board the needs and concerns of private firms.

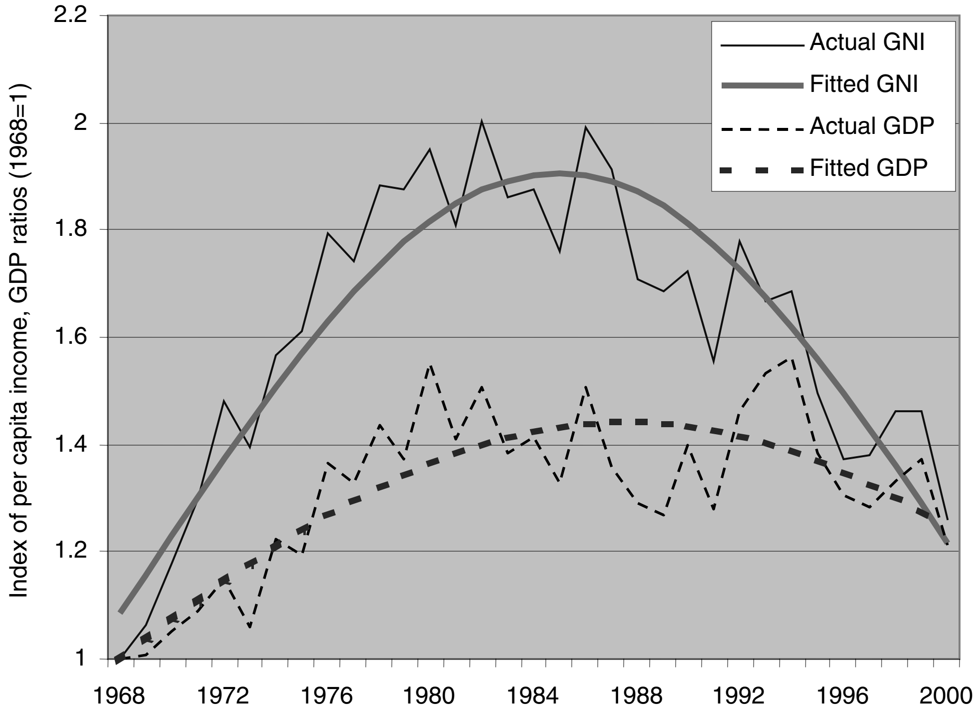
PA relations with the private sector could extend beyond taxation, regulation and policy consultation to a potentially deeper interdependence through public-private partnership in service delivery. The PA's record on the delivery of public services has been mixed, implying room for greater efficiency through competition from other (i.e., non-public) service providers. Although there are cases of private sector participation in investment and service delivery, particularly in health services, even greater partnership with the private sector and with NGOs would benefit the quality and efficiency of service delivery in WBG. By shifting toward an oversight and regulatory role – that is, setting standards for service delivery, coordinating with existing service providers (e.g., NGOs), and contracting out activities and monitoring service quality – the PA could enhance the efficiency of services delivered to the Palestinian population.

<u>Looking ahead</u>. The development of the private sector in WBG has been constrained foremost by the uncertain political situation and the resulting unstable policy environment in which it operates. Although the PA has built considerable capacity to provide public services, its institutional development has lagged behind. As a result, inadequate legal and regulatory institutions, auditing standards, and transparency impose costs on private agents by exacerbating rather than mitigating the uncertain environment. Under the present circumstances of suspended final status negotiations, the PA nevertheless has a range of policy options at its disposal to address these constraints and therefore stimulate a more dynamic private sector role in the future.

Palestinian Economic Growth, Past and Future

Analyzing trade and labor policies and the business environment both pre-Oslo and under the Paris Protocol points to a distorted incentive framework and dependence on the Israeli economy, with Palestinian production focused on low value-added activities. Since 1967, Palestinian economic development has followed a model of integration with Israel, characterized by convergence or catching up with the Israeli economy. But rapid growth did not materialize in WBG. There was some convergence in incomes, especially during the 1970s and early 1980s, driven by short-run gains from market access, worker remittances and higher incomes. But these were offset by long-run losses due to low productivity, vulnerability to external shocks, and weak competitiveness, which eventually led to diverging economic performance, as WBG fell further behind (see Figure 6).

Figure 6: Convergence in GNI and GDP per Capita between WBG and Israel



<u>Paris Protocol and post-Oslo growth</u>. The Paris Protocol aimed to correct some of the observed development disparities, especially on the trade and income side, by improving the environment for private investment and growth in WBG through eliminating Israeli trade barriers on Palestinian agricultural products, removing restrictions on economic activities, reducing political and economic uncertainty by phasing-out military occupation, developing financial institutions, and creating a legal and regulatory framework. The Paris Protocol also led to the revenue-sharing, or clearance, mechanism under which Israel transferred the taxes it collected from trade, purchase and value-added taxes on behalf of the PA, less a 3 percent administrative fee. These measures were accompanied by substantial donor support in terms of infrastructure investment and technical assistance. Nevertheless, the economic integration model failed as incomes diverged between Palestinians and Israelis during the Interim Period.

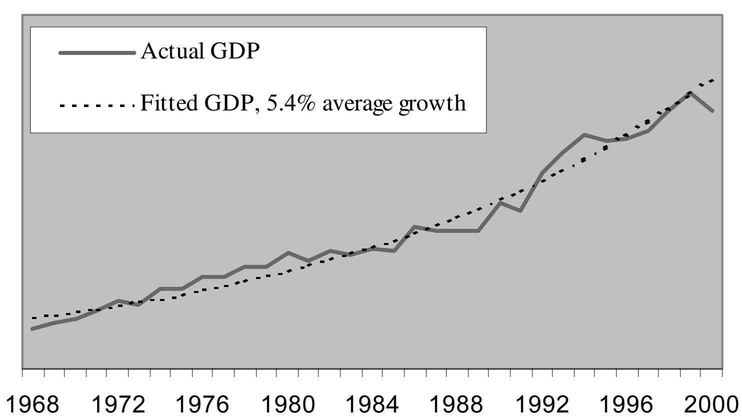
Palestinian economic output was erratic post-Oslo, with distinct episodes mirroring the volatile evolution of political relationships with Israel, particularly vis-à-vis the degree of internal and external closures. In the initial post-Oslo years the economy experienced a return of nationals and large inflows of public and private capital as the result of positive expectations regarding the peace process. But two years of intermittent external closures in 1995-96 and a sharp decline in Palestinian labor flows to Israel precipitated economic recession.

From 1997 to September 2000, closures were less frequent, labor flows to Israel grew dramatically, and transactions costs fell while private investment increased. The Palestinian economy also benefited from an economic boom in Israel, through enhanced opportunities for exports of Palestinian goods and labor. But the outbreak of the intifada in late September 2000 halted the economic recovery and again demonstrated the negative impact of closures on economic growth.

Palestinian economic growth measured by gross domestic product (GDP) is highly volatile, but nevertheless averaged 5.4 percent annually between 1968 and 2000, or 2.5 percent in per capita terms. The post-Oslo period did not lead to a higher growth path, as anticipated, and the improved performance from 1998 to the first part of 2000 merely returned GDP growth to its historical trend (see Figure 7).

This performance was driven by factor accumulation – that is, through added capital and labor – rather than productivity growth which averaged negligible levels. Total factor productivity growth averaged a disappointing 0.3-0.4 percent per year during 1969-2000. The fact that capital stock growth did not take off after Oslo in spite of large inflows of official development assistance implies no dramatic change in incentives to invest in business modernization or expansion. Moreover, most capital expenditures went to construction rather than to productive activities, suggesting limited imports of machinery and technology to raise productivity. The Palestinian economy continued to depend on Israeli goods and labor demand, which did not allow the Palestinian private sector to diversify its risk and entailed significant trade diversion and high domestic wages, as discussed in detail above.

Figure 7: Real GDP, 1968-2000 (1986 NIS)



Modeling future growth potential. Looking to the future, this analysis estimates Palestinian GDP growth over the next decade based on different scenarios of economic and political relations with Israel. In contrast to the partial equilibrium trade, labor and private sector assessments above, this portion of the analysis combines in a consistent framework the demand and supply conditions on goods and factor markets by describing the economic relations among households, producers, the government, and the rest of the world using a dynamic general equilibrium model calibrated for the Palestinian economy. Seven sectors are modeled – agriculture, manufacturing, construction, transport and communications, commerce and tourism, other private services, public services – and two trade partners are considered, Israel and the rest of the world. The model also reflects the existing trade and fiscal arrangements with Israel as of September 2000. GDP growth in the model arises from endogenous labor supply, capital accumulation in productive activities, and productivity increases, the latter depending on the degree of competition, openness, and movement restrictions.

Five scenarios are constructed to reflect potential future economic relations between WBG and Israel. Together they represent a range of policy options and varying degrees of cooperation on the political and economic fronts. No particular likelihood is attached to any of these scenarios, given the uncertainty of future directions of the peace negotiations. The scenarios reflect possible growth paths for the Palestinian economy, from continued crisis under Scenario 1, to a return to pre-crisis conditions under Scenario 2, as well as more rosy prospects following a resolution of the ongoing crisis and a peace agreement (Scenarios 3, 4 and 5).

The latter scenarios reflect a range of economic strategies for WBG as follows:

- Scenario 3 describes continued economic integration with Israel and an improved customs union;

- Scenario 4 reflects more separate economies and a non-discriminatory trade policy; and

- Scenario 5 involves Palestinian policy autonomy in a cooperative environment and a free trade area between WBG and Israel.

Four different exogenous variables are used to build these scenarios: (i) the degree of closures and confrontations, (ii) the level of transactions costs, (iii) the number of Palestinian workers in Israel, and (iv) the nature of trade arrangements (see Table 3). The intensity of Israeli closures is directly linked to the mobility of goods and people within WBG and between WBG and external partners, thus affecting transport costs and transactions costs more broadly.

Table 3: Assumptions for Five Scenarios

Scenario	Closures & Confrontation	Transactions costs	Workers in Israel	Trade Regime
1	Persist until 2010	Very high until 2010	70,000 in 2010	Customs Union
2	Peak in 2002, end in 2003	Same as in 2000	145,000 in 2010	Customs Union
3	Peak in 2002, end in 2003	20% lower than in 2000	165,000 in 2010	Customs Union
4	Peak in 2002, end in 2003	20% higher than in 2000	70,000 in 2010	Non-Discriminatory
5	Peak in 2002, end in 2003	20% higher than in 2000	145,000 in 2010	Free Trade Area

Predicted outcomes. Testing these different scenarios of economic relations between WBG and Israel, the simulation exercise yields the following results for Scenarios 1-5:

(1) a continuation of the crisis would have dire consequences for the Palestinian economy and its population, including declining per capita incomes, stagnant exports, and poverty rates over 50 percent;

(2) a return to the situation prevailing in September 2000 represents a muddle-through solution of stagnation and increased reliance on Israel;

(3) a successfully implemented Paris Protocol would lead to high per capita incomes and modest unemployment, but would still fail to generate high sustainable economic growth through exports and productivity gains;

(4) an economic separation (through a more autonomous and neutral trade regime and lower labor outflows to Israel) aimed at diversifying the Palestinian economy away from Israel toward greater integration into global markets would bring important dynamic gains in terms of investment and productivity leading to strong export-driven GDP growth, but with costs to society through higher unemployment; and

(5) a further integration with Israel through an FTA would lead to mediocre GDP and export levels but also lower unemployment, increasing Palestinian economic dependency on Israel.

The simulation results of the five scenarios are illustrated in Figures 8, 9, 10 and 11 and reported in Table 4 below.

Figure 8: Real Income Per Capita, Different Scenarios (1998 US$)

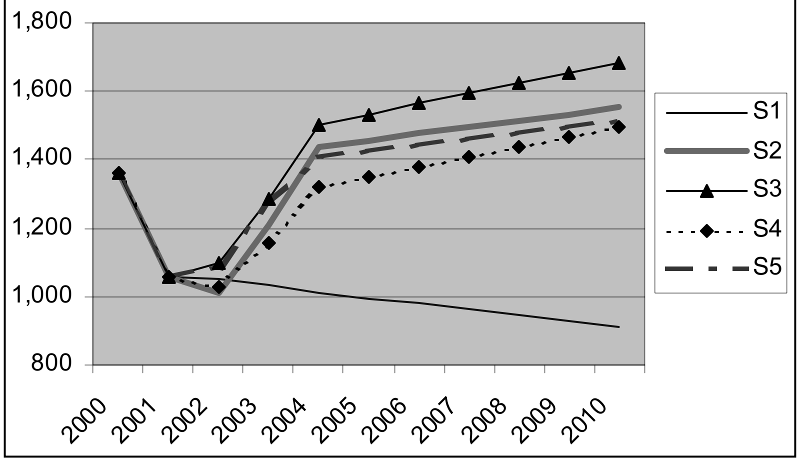


Figure 9: Real GDP, Different Scenarios (1998 US$ mn)

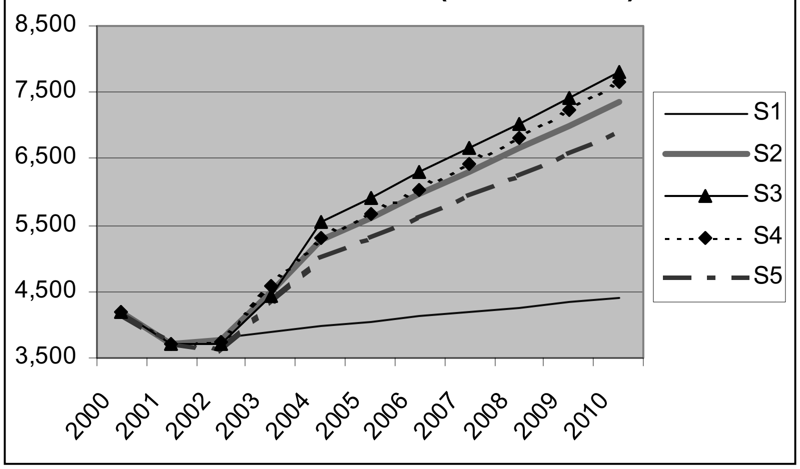


Figure 10: Exports and TFP 2010, Different Scenarios

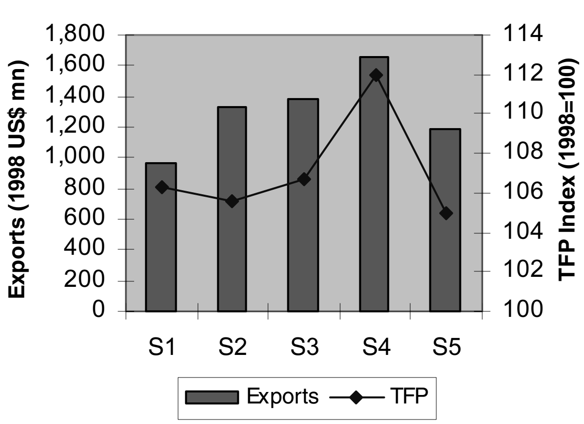


Figure 11: Unemployment and Poverty 2010, Different Scenarios

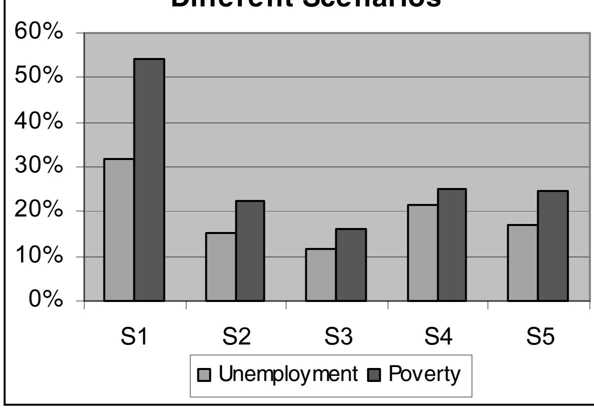


Table 4: Simulation Results					
Scenarios	**1**	**2**	**3**	**4**	**5**
Growth rates 2000-2010 (%):					
Real Income per capita	-4.0	1.3	2.1	1.0	1.0
Real GDP	0.5	5.8	6.4	6.2	5.1
Growth rates 2005-2010 (%):					
Real income per capita	-1.8	1.3	1.9	2.1	1.2
Real GDP	1.7	5.6	5.7	6.2	5.4
Capital stock per capita	-3.7	3.8	4.4	4.6	3.4
Total factor productivity	0.3	0.5	0.3	1.0	0.5
Imports	0.4	2.7	3.2	3.3	2.6
Exports	3.2	6.4	6.0	8.6	6.2
Population	3.3	3.3	3.3	3.3	3.3
As a share of GDP in 2010 (%):					
Exports	22.0	18.0	17.7	21.7	17.2
of which to Israel	20.1	15.4	15.1	15.9	14.8
Imports	56.0	55.4	54.9	52.8	59.7
of which from Israel	41.6	40.9	40.6	39.5	40.7
Private consumption	93.6	84.6	85.3	78.9	88.2
Productive investment	10.5	20.5	20.5	22.0	20.4
Tax revenue	22.1	22.4	22.3	19.4	20.7
Other items (%):					
Unemployment rate in 2010	31.8	15.4	11.7	21.4	16.8
Labor flows to Israel (% employment)	11.2	21.5	25.2	9.6	22.4
Poverty rate in 2010	54.0	22.4	16.0	25.2	24.5
Real per capita income in 2010 (Index 2000 = 100)	66.7	114.2	123.7	110.0	111.0

Scenarios 1 and 2 represent political developments but no fundamental change in policies governing economic relations between WBG and Israel. The predicted outcomes suggest that under these assumptions the Palestinian economy is likely to remain trapped in a low-growth low-income equilibrium. Scenario 3 – representing no change in trade policy but improved mobility and lower transactions costs – predicts a small improvement over historical output growth, higher income growth, and the most rapid recovery in per capita incomes, but weak export performance and continued dependence on Israel through the de facto one-sided trade regime and the distorted labor market and attendant underutilization of human capital. Future scenarios characterized by new trade policy – either through economic separation and a non-discriminatory trade regime (Scenario 4) or through an FTA and continued labor market integration (Scenario 5) – involve varying degrees of decision-making flexibility on the Palestinian side and different degrees of economic dependence on Israel. Scenario 4 shifts to a higher export and productivity growth path through trade diversification toward the rest of the world, but incomes recover more slowly due to smaller labor flows to Israel. Under the FTA in Scenario 5, continued dependence on Israel through trade and labor flows leads to only modest gains from Palestinian trade flexibility with other countries, while per capita incomes and poverty rates in 2010 are comparable to those under Scenario 4.

<u>Trade-offs and welfare implications</u>. The predicted outcomes of the five scenarios illustrate the complex interplay of economic variables associated with different trade regimes, border arrangements, and the implied transactions costs and labor flows. The preceding analysis spells out the trade-offs that are likely to face Palestinian policymakers in the context of a peace agreement with Israel. The various policy choices have very different implications for poverty in WBG. An improved CU (Scenario 3) generates the greatest gains with respect to per capita income and poverty. But this projected growth is driven by workers' remittances from Israel rather than domestic productivity growth, translating into larger near-term benefits but at a cost to long-term development.

On the other hand, economic growth is highest under an NDTP due to strong export and productivity performance (consistent with the partial equilibrium Chapter 2 conclusion that an NDTP leads to better trade outcomes than a CU and an FTA) and reduced vulnerability to external shocks, but unemployment and poverty are substantial. The challenge for policymakers will be to balance the near-term and long-term costs and benefits. Addressing welfare concerns adequately – particularly poverty – will continue to be crucial in the future, especially under Scenarios 4 and 5, reinforcing the need for well-targeted and comprehensive safety net programs to protect the poor.

<u>High-case trade outcomes</u>. Whereas Scenarios 1-5 represent most-likely outcomes, it is possible that a future peace agreement could be accompanied by greatly expanded Palestinian trade, particularly with Arab League countries. This type of "peace dividend" is modeled by a large cumulative decline in trade barriers with third-party markets excluding Israel. The result is higher annual growth rates by 0.5-0.7 percentage points per year, but with especially large gains under the NDTP of Scenario 4, in which annual export growth is estimated to reach 10 percent between 2005 and 2010 (compared to 8.6 percent in Table 4). These high-case scenarios of expanded trade involve higher per capita incomes and lower poverty relative to the most-likely outcomes.

<u>Downside risks</u>. The ability to implement policy changes effectively and the subsequent response of the Palestinian private sector will be central to future growth outcomes. There are very real downside risks relating to policy changes following a

final status agreement, such as increased transactions costs due to inefficient border administration or protective tariff rates, for example. Moreover, continued risk and uncertainty will cause further decline in private investment, leading to lower per capita income growth and very high poverty rates. Low-case scenario estimates suggest that future economic policy choices are not straightforward and the inherent risks under *any* scenario are non-negligible.

Conclusions

The Palestinian economy has exhibited modest economic performance for the past three decades, including the most recent Interim Period during which better economic outcomes were anticipated under the Paris Protocol. The growth outcomes observed post-Oslo illustrate the close inter-linkages between political and economic factors. The Paris Protocol provided for controlled Palestinian economic integration with Israel, but did not adequately separate political pressures from economic considerations. Disputes that emerged in the context of economic transactions lacked sufficient settlement mechanisms, leading to worse economic outcomes and at the same time inflaming political pressures. Economic arrangements favored Israel and maintained the dependent development path of the Palestinian economy. And Israeli closure policy created extreme economic hardship for the Palestinians and increased the level of frustration regarding unmet expectations and a lack of progress toward independence.

Factors other than distortionary trade and labor policies complicated the economic environment. The interim nature of the peace accords and the inherent limits on Palestinian sovereignty generated uncertainty and risk, especially in the context of periodic Israeli closures and severe mobility restrictions on goods and labor. The impact on transactions costs pushed Palestinian production costs above competitive levels. This uncertain climate was further hampered by weak institutional structures relating to investment, namely inadequate legal, regulatory and financial institutions to protect private investment, as well as anticompetitive practices effectively condoned by the PA. As a consequence, the stifled Palestinian private sector failed to stimulate sustained growth and job creation.

In light of Israel's central role in the Palestinian economy, alternative models of future Palestinian economic development will depend on the nature of political and economic relations with Israel under a final status agreement. The overriding objective of future economic relations between West Bank and Gaza and Israel should be sustained economic growth, mutual benefit, and a level playing field. Although final status negotiations are currently stalled, a future peace agreement could lead to one of the following options: continued economic integration, non-cooperative economic separation, or Palestinian economic policy autonomy in a cooperative environment. Scenarios 3, 4 and 5 developed herein illustrate the projected economic outcomes associated with each policy option, and the implied trade-offs among GDP growth, productivity, incomes, unemployment and poverty.

Comparing the results of the different policy scenarios does not point to a unique or optimal solution, given that economic performance measured by real GDP growth does not differ significantly in the long run (except under a continuation of the crisis). But the factors driving growth vary significantly. Under increased economic integration but limited policy autonomy, slow productivity growth and capital accumulation are compensated by greater access to the Israeli labor market, whereas under economic separation, reduced access to the Israeli labor market and higher transactions costs are offset by a more liberal neutral trade regime that reduces trade diversion, promotes competition and encourages investment and more productive technologies, but at a higher social cost with respect to unemployment.

Each scenario involves different levels of policymaking autonomy and sovereignty for the Palestinians, and as such may be more or less politically tenable. Any future peace accord and related economic agreement will need to isolate political variables from the economic sphere, in order to avoid repeating the current situation in which economic objectives are undermined by competing constituent demands in an unsettled political environment. But under any scenario, Israel will continue to be a very important partner for the West Bank and Gaza.

Introduction